

Managing Tax Debt in Tough Economic Times

Welcome back to *The Legal Lounge*. As foreshadowed in my last article, I intend to focus this year on some broader aviation and other commercial and legal issues that may affect aviation businesses. In this edition, I delve into the vexed issue of managing tax debt in tough economic times.

The ideal world

In the ideal world, when goods are delivered and services are provided, the happy customer would always pay on the spot, or within the required period specified on the invoice. Businesses would immediately put aside the required GST and withholding taxes, pay all accounts, creditors and wages due, and put aside the required PAYE and any other deductions required from the wages (Kiwisaver, student loan, child support etc), which would be duly paid to IRD on time and in full. The happy business owners would then retreat to the “Local” and engage in light conversation with their peers to contemplate how they intend to spend their hard earned profit at the end of the financial year.

The commercial reality

The commercial reality is, however, often somewhat different. The global financial crisis seems to have no end. Customers are often slower to pay, and if combined with a downturn in sales or revenue, or an unexpected event, cash flow difficulties can quickly emerge. Business finance is harder to get. For many small to medium sized businesses under financial strain, paying the ‘essentials’ to keep a business running is the utmost priority, and keeping current with tax obligations can often become the first casualty. Before long, tax bills can build up, with late payment penalties and use of money interest quickly accumulating. For a business facing arrears of PAYE and/or GST, possibly combined with looming provisional or terminal income tax payments, it may not take long for the situation to get out of hand and appear to be insurmountable. However, the worst thing any taxpayer can do in this situation is bury their head in the sand.

2002 - Introduction of new tax debt relief provisions in the Tax Administration Act 1994

In 1999 Parliament’s Finance and Expenditure Select Committee held an inquiry into the powers and operation of the IRD. One aspect of the inquiry focused on the scope and flexibility of the powers of the Commissioner of Inland Revenue (the Commissioner) to enter into instalment arrangements for tax arrears, and to provide financial relief to taxpayers suffering from serious financial hardship.

This led to the enactment in 2002 of new debt and hardship rules in the Tax Administration Act 1994 (TAA), which codified the following principles:

- The Commissioner must maximise the recovery of tax, but not to the extent that recovery is inefficient or places a natural taxpayer in serious hardship
- If the Commissioner can collect more tax over time through an instalment arrangement (as opposed to liquidation or bankruptcy) the Commissioner is required to enter into the arrangement, and any amount of tax not recovered is to be written off
- Amounts written off cannot be reinstated

- Late payment penalties will cease to apply to the debt when taxpayers contact IRD seeking to negotiate a repayment arrangement

These powers must be exercised consistently with the Commissioner's 'care and management' obligations under s6 and 6A of the TAA. This imposes a duty on the Commissioner to collect over time the highest net revenue that is practicable within the law, having regard to the resources available to the Commissioner, the importance of promoting voluntary compliance by taxpayers with their tax obligations, and compliance costs incurred by taxpayers in meeting their tax obligations.

Inland Revenue also has a statutory duty to protect the integrity of the tax system. The Courts have held that in some cases, this may mean that the Commissioner may deny a taxpayer financial relief if it is considered that to do so may compromise the integrity of the tax system. Such a situation may arise, for example, if a taxpayer is considered to have committed tax evasion or a similar act; or if a taxpayer has consistently failed to meet their tax obligations over a long period of time.

Requesting tax relief pursuant to an instalment arrangement and /or a write off of tax

All taxpayers may apply to IRD to enter into an instalment arrangement for tax arrears (it should be noted that "tax" is defined for the purposes of the tax relief provisions to include interest and penalties). Natural persons may also apply for a write off of some or all tax under the serious hardship provisions in the TAA. For corporate entities, an instalment arrangement might also result in a write off of some tax, if the tax is considered to be unrecoverable.

While individuals and entities may apply directly to IRD to enter into an instalment arrangement or to apply for a tax write off, in my view it is strongly advisable to seek professional advice and assistance from an accountant or lawyer before doing so.

In my experience in assisting a number of taxpayers dealing with tax arrears, those who have initially dealt directly with IRD have often entered into an instalment arrangement that is not sustainable or in their interests. If a taxpayer fails to make a scheduled payment, or fails to keep up with their current tax obligations as they fall due, this could lead to the instalment arrangement being cancelled by the Commissioner, and is also grounds for the Commissioner to refuse to agree to a new instalment arrangement under s177B of the TAA. This can lead the taxpayer down the slippery slope towards bankruptcy or liquidation.

Taxpayers may also agree to pay the full amount of a tax debt owing under an instalment arrangement when this is not financially sustainable, and a partial write off should have been sought. In my experience, businesses are often able to put a stronger case forward for tax relief if they have consulted with and involved their accountant in any application put forward to IRD.

The fact that the Commissioner has agreed to enter into an arrangement over a tax debt also does not protect the taxpayer from other possible legal ramifications. For example, a company may have entered into an instalment arrangement which involves a write off of some PAYE and GST arrears. In such cases, the company and its Directors could still potentially face prosecution action for failing to pay those amounts. It is therefore vital to seek professional advice and assistance before making such an application, to ensure the best possible case is put forward to IRD, and to understand any collateral implications that could still arise notwithstanding a write off any tax agreed to.

A number of other important considerations should also be kept in mind, as follows:

- Applications for tax relief should be made as soon as possible. If an instalment arrangement is agreed to, late payment penalties cease to apply to the debt from the date of application. Although use of money interest will still accumulate, it will effectively also be wrapped up into the total agreed settlement amount.
- It is vital that all tax return filing obligations are up to date. Even if a taxpayer is unable to pay the tax owing, failing to furnish returns is an offence and will itself be a bar to an instalment arrangement being agreed to
- While it may not always be achievable, and the Commissioner has full discretion to write off any amount and type of tax, it is generally preferable where possible to ensure the offer covers the full amount of any core taxes owing, especially in relation to PAYE and other associated wages deductions and contributions. This will increase the likelihood of a repayment/debt write off proposal (of interest and penalties) being accepted, and it reduces the risk of possible prosecution action for non-payment of such amounts
- Notwithstanding the previous point, it is absolutely essential that taxpayers only offer to pay what they can realistically afford. Missing one or more payments under an instalment arrangement or not meeting subsequent tax obligations (eg PAYE) can lead to an instalment arrangement being cancelled and further relief being denied by the Commissioner. Businesses should therefore consult with their accountant, and be conservative in calculating what they can realistically afford to pay while also keeping up with all anticipated outgoings, including on-going tax payment obligations, before approaching IRD with an offer
- If IRD require further information, this must be supplied within 20 working days. Failure to do so may lead to the application being rejected, and a new application may need to be submitted. This has consequences for the date when penalties cease to apply (not to mention IRD's attitude towards any new application).

What to do if you can't maintain an instalment arrangement

It is absolutely vital to contact your professional adviser and/or IRD at the first opportunity if you think you may not be able to make a scheduled payment under an instalment arrangement. IRD is much more likely to agree to a variation of the instalment arrangement if they are contacted prior to the arrangement being breached.

If a taxpayer does not contact IRD in advance and subsequently defaults on payments, the Commissioner may cancel the arrangement and may refuse to renegotiate or enter into a new arrangement. In such cases, the outstanding tax debt (excluding any amount already written off, which cannot be reinstated) is called up and unless it is able to be paid in full, there is a high risk of liquidation or bankruptcy proceedings being initiated against the taxpayer.

If a company has been served with statutory demands requiring an outstanding tax debt to be paid, legal advice and assistance should be sought without delay. In my experience, once liquidation proceedings are filed and served by IRD, it is considerably more difficult to negotiate a successful outcome, and the Courts have only limited ability to intervene.

Further, once pending liquidation action by Inland Revenue has been notified in the *Gazette* and published in newspapers, this may cause lenders to call up securities and trade creditors to stop supplying credit. It may then become impossible for the business to continue trading, even if it might otherwise have been able to reach a settlement with IRD on the tax debt. Seeking early assistance from your professional advisers is therefore in your best interests.

Summary

What is most essential in managing any tax debt is to seek assistance from your professional advisers early on, and if relief is required, to apply to IRD as soon as possible. Any instalment arrangement or tax debt settlement proposal should at the very least be put together in consultation with your accountant, and any offer should be as realistic as possible to avoid possible default on an instalment arrangement. Where a default appears imminent, immediate disclosure should be made to IRD, to maximise the opportunity to try and seek to renegotiate an instalment arrangement. If matters look like they are escalating towards liquidation or bankruptcy proceedings, legal advice should be sought at the earliest opportunity.

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